Council of Institutional Investors®
The voice of corporate governance

Via Electronic Mail

May 31, 2018

Business Framework Directorate
Department for Business, Energy & Industrial Strategy
1st Floor, 1 Victoria Street
London, SW1P 0ET

Dear Business Frameworks Directorate:

I am writing on behalf of the Council of Institutional Investors (CII), a nonprofit, nonpartisan association of public, corporate and union employee benefit funds, other employee benefit plans, state and local entities charged with investing public assets, and foundations and endowments with combined assets under management exceeding $3.5 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families. Our associate members include a range of asset managers with more than $25 trillion in assets under management.[1]

The purpose of this letter is to respond to the consultation entitled "Insolvency and Corporate Governance".[2] We generally support the proposed revisions and offer the following comments for your consideration in response to some of the specific questions raised.

As a leading voice for long-term investors, CII welcomes the opportunity to offer its perspective and recommendations. Our specific comments follow as answers to the questions posed in the March 2018 Consultation Document.[3] Because CII does not have policies or public positions covering each of the proposed revisions, we have limited our responses to only those questions upon which our member-approved policies or public positions touch.

Sale of Businesses in Distress

Question 1: Do you think there is a need to introduce new measures to deal with the situation outlined?

CII generally supports adopting new measures to address the sale of insolvent subsidiary companies when the sale harms creditors. We do not offer any specific proposals at this time. We

[1] For more information about the Council of Institutional Investors ("CII"), including its members, please visit CII's website at http://www.cii.org/members.
[2] *See* Department for Business, Energy & Industrial Strategy, Insolvency and Corporate Governance (March 20, 2018), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/691857/Condoc_-_Insolvency_and_Corporate_Governance_FINAL_.pdf.
[3] *See id.*

also express no opinion regarding BEIS's specific proposal to impose liability on parent companies' directors.[4]

We do, however, propose a principle that should guide BEIS's approach: any new measure should be narrowly tailored enough so as to not discourage economically beneficial investment activity. The imposition of excessive liability on the directors of parent companies could chill this activity.

As the BEIS Consultation Document recognizes, the parent-subsidiary structure enables companies to separate higher risk business ventures from those that are more stable and profitable.[5] This encourages companies to innovate without risking substantial damage to their existing business. By protecting parent companies from the losses of subsidiaries, this structure encourages parent companies to create new start-ups and grant loss-making subsidiaries the time needed to turn around.[6] Parent companies can provide sufficient financial support to allow subsidiaries to continue operating when the latter companies would otherwise fail.[7] The parent may also decide to sell the subsidiary to a new investor who will provide the funding necessary to restore the subsidiary to profitability.[8] In many cases, a sale offers the best means to serve the interests of all parties.[9]

Additionally, *wholly-owned* subsidiaries exist to benefit the parent company.[10] That is not to say that parent companies are entirely free to use subsidiaries as they will.[11] Nor does it mean creditors of subsidiaries should be left without rights when a parent company's operation of a subsidiary harms the subsidiary's creditors.[12] The remedies available to creditors, however, should respect the primary purpose for which (at least) some subsidiaries are created.

The preceding paragraph addresses only the parent-subsidiary relationship's implications for crafting creditors' remedies. CII does not support allowing parent companies to use without limit subsidiaries, even wholly-owned subsidiaries, in any manner that the parent companies deem beneficial. For instance, companies should not engage in any behavior that runs contrary to principles of good corporate governance or transparency. Corporate governance structures should enhance a company's accountability to its shareholders.[13] No company should take any action with the purpose of reducing accountability to shareholders.[14] Every company should also practice

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[4] *See id.* at 9-11.
[5] *See id.* at 7.
[6] *See id.*
[7] *See id.*
[8] *See id.* at 8.
[9] *See id.*
[10] *See e.g., Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 173 (Del. Ch. 2006) ("Wholly-owned subsidiary corporations are expected to operate for the benefit of their parent corporations; that is why they are created").
[11] *See e.g., Sinclair Oil Corp. v. Levien* 280 A.2d 717, 720 (Del. 1971) (holding that a parent company owes a fiduciary duty to a subsidiary in a parent-subsidiary transaction when the parent receives something from the subsidiary to the exclusion and detriment of the subsidiary).
[12] *See Trenwick Am. Litig. Trust*, 906 A.2d at 173 (detailing the remedies available to such creditors under Delaware law).
[13] Council of Institutional Investors, Corporate Governance Policies § 1.4 Accountability to Shareholders (Updated September 15, 2017).
[14] *Id.*

transparency in its corporate governance procedures and policies.[15] In a parent-subsidiary structure, meaningful transparency and accountability require that the parent and subsidiary companies provide full disclosure to investors about the parent-subsidiary relationship and the related material risks for shareholders.[16]

The parent-subsidiary structure serves as a useful tool for parent companies to engage in new business ventures or fund short-term loss-making but potentially valuable companies while limiting the risk posed to the parent company and its shareholders. Any new measure should avoid undermining this benefit or substantially impairing the central purpose for which companies create wholly-owned subsidiaries.

Strengthening Corporate Governance in Pre-Insolvency Situations

Question 12: What more could be done through a revised Stewardship Code or other means to promote more engaged stewardship of UK companies by their investors, including the active monitoring of risk? Could existing investor initiatives to hold companies to account be strengthened (e.g., through developing the role of the Investor Forum)? Could better arrangements be made to ensure that lessons are learned from large company failings and controversies?

CII generally supports investor efforts to voluntarily assume a greater stewardship role over the companies in which they invest. We recognize that institutional investors control substantial amounts of wealth and consequently wield significant economic and political capital. Accordingly, we encourage our members to foster an environment of transparency and accountability by publicly disclosing their own proxy voting guidelines, proxy votes cast, investment guidelines, names of governing-body members, and an annual report on holdings and performance.[17] We further acknowledge that transparency from institutional investors benefits capital markets by fostering greater investor confidence.[18]

CII also supports investor efforts to maximize the value of their investment by extending engagement beyond merely voting at a company's Annual Meeting.[19] We hold, however, that any such efforts should be voluntary. Investors should be actively involved in corporate governance to the degree that involvement enables them to achieve better investment outcomes.[20] In determining

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[15] *See id.* § 1.3 Disclosed Governance Policies and Ethics Code (stating that every company should have written, disclosed corporate governance policies and procedures).

[16] For more information on a particular parent-subsidiary structure that poses substantial risks to investors and how greater disclosure requirements can reduce these risks, *see* Brandon Whitehill, Research Analyst, Council of Institutional Investors, "Buyer Beware: Chinese Companies and the VIE Structure," (December 2017), https://www.cii.org/files/publications/misc/12_07_17%20Chinese%20Companies%20and%20the%20VIE%20Structure.pdf.

[17] Council of Institutional Investors, Policies on Other Issues, Best Disclosures Practices for Institutional Investors, http://www.cii.org/policies_other_issues.

[18] *See* Investors' Working Group, "U.S. Financial Regulatory Reform: The Investors' Perspective," 16 (July 2009), https://www.cii.org/files/issues_and_advocacy/dodd-frank_act/07_01_09_iwg_report.pdf.

[19] *See* Insolvency and Corporate Governance at 25.

[20] *Cf.* Council of Institutional Investors, "Portfolio Risk Reduction and Performance Enhancement: A Spectrum of Activism Practices for Institutional Investors" 1 (last amended August 5, 2005) (discussing the ability of large investors to "take steps to increase the chance that the best will actually occur").

their methods and degree of involvement, investors should adopt the approach that best aligns with their objectives, resources, philosophy, and investment strategy.[21]

We are concerned about BEIS's focus on shareholder responsibilities in preventing corporate failures.[22] Ultimate responsibility for stewardship and risk management rests with a company's directors.[23] Under Section 172 of the UK Companies Act, directors bear a duty to shareholders to promote the long-term success of the company.[24] Promoting long-term success necessitates effective risk management. Effective risk management requires the board of directors to regularly and meaningful communicate with management, outside advisors, and among its committees about the company's material risks and risk management processes.[25] The board should also facilitate investor stewardship by providing, at least annually, shareholders with sufficient information to assess the board's performance of its risk management duties.[26] This information may enable investors to hold directors accountable.[27] Responsibility for the success or failure of a company's risk oversight remains with the directors.[28]

Question 14: There are perceptions that some directors may not be fully aware of their duties with regard to commissioning and using professional advice. Do you agree, and if so, how could these be addressed?

CII expresses no opinion regarding whether directors in the United Kingdom are fully aware of their responsibilities with respect to professional advice. If BEIS determines that directors lack this awareness, CII policies offer guidance in better apprising directors of their duties. Additionally, the Financial Reporting Council should consider adding to Section C.3 of the Corporate Governance Code a provision that expressly lays out director duties with respect to professional advice. This provision would provide easily accessible and clear guidance to directors.

The following CII policies are likely to focus director attention on duties with respect to professional advice. Directors have an obligation to independently become and remain familiar with company operations.[29] Directors should not rely exclusively on information provided by others.[30] This provision emphasizes directors' obligations to exercise their independent judgment.

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[21] *See* Council of Institutional Investors, "Getting Involved in Corporate Governance: A Guide for Institutional Investors" 1 (February 2012), https://www.cii.org/files/publications/governance_basics/04_28_14_getting_involved_in_CG.pdf.
[22] *See* Insolvency and Corporate Governance at 25.
[23] *See* Corporate Governance Policies § 2.7 Board's Role in Risk Oversight ("The board has ultimate responsibility for risk oversight"); *see also* Financial Reporting Council, Corporate Governance Code Provision A.1 Main Principle ("Every company should be headed by an effective board which is collectively responsible for the long-term success of the company").
[24] *See* UK Companies Act, 2006, c. 46, § 172 (establishing duty to act in the manner that the director, in good faith, deems most likely to promote success of company, including the likely long-term consequences of any action).
[25] Corporate Governance Policies § 2.7.
[26] *See id.*
[27] *Cf.* "Portfolio Risk Reduction" at 2 (stating that an institutional investor seeking to promote good corporate governance should at minimum obtain useful information on the company's governance practices).
[28] *See* Corporate Governance Policies § 2.7.
[29] *Id.* § 2.12a Informed Directors.
[30] *Cf. id.* (stating that directors should not rely exclusively on information provided by the CEO).

Boards should also periodically review their own performance.[31] Such review will likely sharpen directors' focus on their duties and how they carry out those duties. Boards should also disclose to shareholders the process for selecting committee members, including members of the audit committee.[32]

Several CII policies specifically address directors' role with respect to professional advice from auditors and compensation consultants. The audit committee should fully exercise its authority to hire, compensate, oversee, and (if necessary) terminate the company's independent auditor.[33] The committee should also consider periodically changing the auditor.[34] CII provides a nonexhaustive list of 18 factors audit committees should consider in determining whether to change the auditor.[35] Periodic consideration of these factors will likely focus director attention on the duty to exercise independent judgment and oversight regarding professional advice. The audit committee report should also provide meaningful information to investors about how the committee carries out its responsibilities, including a fact specific explanation for not changing the company's auditor if (1) the current auditor has been engaged for 10 consecutive years or (2) the committee's review has identified substantial deficiencies.[36] If it decides to change the independent auditor, the committee should also provide shareowners with a plain-English explanation of the reasons for this change.[37] These reports will likely further focus director attention to their duties. Furthermore, audit committee charters should provide for annual shareowner votes on the board's choice of independent auditor.[38] If the board's selected auditor fails to receive a majority of votes cast, the committee should reconsider its choice and the board should engage with major shareowners on the issue.[39] This accountability to shareholders with respect to auditors will further serve to apprise directors of their duties.

Similarly, the renumeration committee should retain and terminate outside experts, including consultants, legal advisors, and any other advisors when it deems appropriate for determining executive compensation.[40] Advisors should be independent of the client company and its executives and directors.[41] The committee should develop and disclose a formal policy regarding compensation advisor independence and should annually disclose an assessment of advisor independence, including a description of the nature and dollar amounts of services commissioned from advisors.[42] Additionally, the committee should have the ability to hire an independent consultant for assistance in formulating director compensation plans.[43] The annual notice of

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[31] *Id.* § 2.8c Evaluation of Directors; *see also* Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors, to Ann E. Misback, Secretary, Board of Governors of the Federal Reserve System 6 (November 16, 2017), https://www.cii.org/files/November%2016%202017%20FRS%20Letter%20(final).pdf.
[32] *See id.* § 2.5 All-independent Board Committees.
[33] *Id.* § 2.13a Audit Committee Responsibilities Regarding Independent Auditors.
[34] *Id.*
[35] *See id.*
[36] *See id.*
[37] *See id.* § 2.13g Disclosure of Reasons Behind Auditor Changes.
[38] *Id.* § 2.13f Shareowner Votes on the Board's Choice of Outside Auditor.
[39] *See id.*
[40] *See id.* § 5.5g Outside Advice.
[41] *Id.*
[42] *See id.*
[43] *See id.* § 6.2b Outside Advice.

meeting for the annual general meeting should include a summary of any consultant's advice.[44] The committee should further disclose all instances in which a consultant on director compensation was also retained to provide advice on executive compensation.[45] These requirements and disclosures will further focus directors on their duties with regard to professional advice.

Question 17: Is the current corporate governance framework in the UK, particularly in relation to companies approaching insolvency, providing the right combination of high standards and low burdens? Apart from the issues raised specifically in this consultation document, can you suggest any other areas where improvements might be considered?

CII offers two additional proposals for improving corporate governance in the UK. First, we would recommend that the Financial Reporting Council update its Corporate Governance Code by adding a clause to Code Provision C.2.3 stipulating that annual disclosures contain sufficient information for shareholders to assess whether the board is carrying out its risk-monitoring duties effectively.[46] While the disclosures required by the Code likely already meet this standard, an express provision would help ensure fuller disclosure and greater board accountability to shareowners.[47] Such a provision would also help clarify the role that the board and shareowners play in risk management.

Second, we believe that FRC's Corporate Governance Code should be updated to require annual election for all directors.[48] Code Provision B.7.1 currently requires annual election for directors of FTSE 350 companies but permits all other directors to serve three-year terms.[49] These classified boards intrinsically entrench directors and reduce accountability to their constituents, the shareholders.[50] Multiple empirical studies have demonstrated a significant negative correlation between classified boards and firm value.[51] Consequently, due to shareholder efforts the proportion of United States companies with classified boards has shrunk dramatically in the past decade.[52]

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[44] *See id.*
[45] *See id.*
[46] *See* Letter from Todd Noelle, Council of Institutional Investors, to Catherine Woods, Financial Reporting Council 6 (June 11, 2014), https://www.cii.org/files/issues_and_advocacy/correspondence/2014/06_11_14_CII_letter_UK_financial_reporting_council.pdf; Corporate Governance Policies § 2.7.
[47] *See* Letter from Todd Noelle at 6.
[48] Letter from Justin Levis, Senior Research Associate, Council of Institutional Investors, to Chris Hodge, Corporate Governance Unit, Financial Reporting Council 1 (March 4, 2010).
[49] Corporate Governance Code B.7.1.
[50] Letter from Justin Levis at 1.
[51] *See e.g.*, Lucian Bebchuk & Alma Cohen, "The Cost of Entrenched Boards," 78 *J. Fin. Econ.* 409, 430 (2005) (finding that, even controlling for other governance provisions, classified boards are associated with lower firm value as measured by Tobin's Q); Michael D. Frakes, "Classified Boards and Firm Value," 32 *Del. J. Corp. L.* 113, 117 2007) (using multiple valuation models to "document a negative and statistically significant relationship between classified boards and firm value").
[52] *See* Ceres et al., "The Business Case for the Current SEC Shareholder Proposal Process" 6 (Apr. 2017), https://www.ussif.org/files/Public_Policy/Comment_Letters/Business%20Case%20for%2014a-8.pdf ("Ten years ago, fewer than 40 percent of S&P 500 companies held annual director elections compared to more than two-thirds today").

<u>Conclusion</u>

Thank you for the opportunity to comment on the proposed revisions. If you have any questions, please contact me at 202-822-0800 or Brendan@cii.org, or our General Counsel Jeff Mahoney at the same number or Jeff@cii.org.

Sincerely,

Brendan Tyler